VZCZCXRO5256
RR RUEHCHI RUEHDT RUEHHM RUEHNH
DE RUEHKL #1994/01 2930641
ZNR UUUUU ZZH
R 200641Z OCT 06
FM AMEMBASSY KUALA LUMPUR
TO RUEHC/SECSTATE WASHDC 7845
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUEHGV/USMISSION GENEVA 1438
RUCNASE/ASEAN MEMBER COLLECTIVE

UNCLAS SECTION 01 OF 03 KUALA LUMPUR 001994

SIPDIS

STATE PASS USTR - WEISEL AND JENSEN
STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
USDOC FOR 4430/MAC/EAP/J.BAKER
TREASURY FOR OASIA AND IRS
GENEVA FOR USTR

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV EPET MY

SUBJECT: Malaysia Inc. - still profitable? Monthly Economic Update for October 2006

¶1. Summary: Foreign Direct Investment to Malaysia continues to slide, even as FDI to the region soars, according to an UNCTAD report. The government's announced strategy is to be "selective" in an effort to "move up the value chain." While this strategy makes some sense, based on rising wages and the stability and infrastructure Malaysia has to offer, the GoM is not taking the steps needed to attract enough high-end manufacturers to compensate for those they are losing. While the GoM boasts of a handful of successes, the numbers tell the real story - the bandwidth of Malaysia's profitability as a destination for FDI is narrowing. Meanwhile, Malaysia and other ASEAN countries are increasing their pressure on Indonesia to resolve the haze problem. End Summary.

Malaysia Slips in FDI Rankings

¶2. The UNCTAD World Investment Report released October 16 showed that Malaysia fell to sixth place among the ASEAN countries last year in the race to attract foreign direct investment (FDI). FDI inflows to Malaysia in 2005 declined 14%, while inflows to Southeast Asia as a whole increased 45%. The poor showing was presaged in the 2005 Investment Confidence Index published by the consulting firm A.T. Kearney, Inc. This survey asked Global 1000 executives where they planned to make their investments that year; Malaysia failed to make the top 25 list of FDI destinations for the first time since ¶1998.

GOM Seeks Advice, But Will They Take It?

¶3. Malaysian policymakers are aware of the need to upgrade the country's foreign investment regime and have been quietly seeking advice. Our business contacts report they have been invited to several meetings to discuss the investment climate with officials up to and including the Prime Minister, although they add that they have seen no significant changes as a result. Commenting to the press on the UNCTAD report, National Economic Action Council (NEAC) member Datuk Zainal Aznam Yusof defended the government's policies, including rules that assign a 30% equity share to bumiputeras (ethnic Malays) in any new venture outside the export manufacturing sector. However, he also said Malaysia must liberalize its service and industrial sectors to make them more attractive to foreign investors. Our business contacts would agree.

¶4. In a press interview, Mohamed Ariff, Executive Director of the Malaysian Institute of Economic Research (MIER), attributed the lower FDI to Malaysia's policy of "selectivity" in approvals,

pointing to Malaysia's targeted greenfield industries and its goal of attracting manufacturers of high tech and capital intensive products, rather than low-wage, labor intensive industries. Ambassador Thierry Rommel, head of EU Commission delegation to Malaysia, publicly announced that the declining attractiveness of Malaysia as an FDI destination was due to issues regarding availability of skilled labor, visa issuance, intellectual property rights, and lack of transparency and predictability to certain policies and markets.

Penang Strives to Move Up the Value Chain

¶5. Wan Zalina Noordin, CEO of Invest Penang, a state government agency charged with attracting business investment, told econoff that the GoM's strategy was to "move up the value chain." She explained how the government selectively targets hi-tech industries, renewing tax incentives for those companies it sees as meeting the appropriate technology and wage levels, and not discouraging employers of lower skilled workers from moving their manufacturing to China or elsewhere.

¶6. Rod Libby, Managing Director for Linear Semiconductor, a San Francisco-based manufacturer, told econoff that the GoM recently had renewed the company's tax abatement agreement for another ten years and approved a large-scale expansion of the factory. At the other end of the technology spectrum, Mr. Soo Teck Heng, General Manager for Mattel (Malaysia), explained that Mattel had shifted its production of Barbie dolls from Penang to China several years ago as a result of increasing labor costs. The manufacture of toy cars in Malaysia remained profitable, he explained, because it was highly mechanized. Cardinal Health Care, formerly Allegiance, no longer manufactures in Penang after determining that it was no longer profitable, according to one company representative. The company

maintains some staff in Penang who are engaged in "outsourcing." Econoff's taxi driver referred to the shuttered plant as the "rubber glove factory."

¶7. While these developments seem entirely consistent with the strategy described by Invest Penang of moving up the value chain, econoff observed a number of vacant factories in the area, many of which reportedly have remained empty since the 1997 currency crisis.

¶8. Although Invest Penang has been criticized widely in the press for not doing enough to promote the opportunities in the island state, the real problem cited by many businessmen is more a matter of fundamental business climate than advertisement. The most common complaint manufacturers in Penang mentioned to econoff was the poor enforcement of intellectual property rights. A representative of one Penang manufacturer pointed out that his company was resolved to keep manufacturing its more sensitive technology in Singapore, despite higher costs, specifically because of the risk of piracy. Only its basic assembly is done in Malaysia. He said bringing research and development to Malaysia - a stated goal of Invest Penang - was out of the question for his company. Labor costs in Malaysia have increased steadily over the past five years, but improvements in the business climate, including IPR protection, have not kept up.

Despite Declining FDI, Economic Forecasts Are Up
--- ---

¶9. Economic think tank the Malaysian Institute of Economic Research (MIER) has revised its GDP forecast for Malaysia for this year to 5.6% from 5.2% on better-than-expected increase in Malaysian exports to the U.S., EU and Japan. The institute maintains its earlier forecast of 4.8% for 2007 on an expectation of declining demands for exports. MIER executive director Mohamed Ariff said the 4.8% forecast for next year is based on a comparison with expected performance of other countries in the region. The government has projected the Malaysian economy would grow 5.8% in 2006 and 6% in
¶2007.

Indonesia's Smoke Blankets Malaysian Sky

¶10. Malaysia is in the thick of haze season as smoke blankets the sky, blowing in from Indonesian forest fires and plantations practicing slash-and-burn agriculture. Kuala Lumpur has escaped the worst of the haze this year; the southern area of the Peninsula and Sabah and Sarawak in Borneo have borne the brunt of the problem. To help clear the air over Sabah and Sarawak, the Malaysian government has tried to stimulate rain through cloud-seeding at a cost of RM 50,000 per flight (about USD 16,600), but so far with little result.

Effect of Haze on Tourism

¶11. A representative from the Ministry of Tourism Promotion Board told EconFSN that the Board set up an ad hoc division to consider the effect of haze on tourism. While the Board has not received any reports of inbound cancellations from overseas travel agents, Southeast Asia is becoming known for this annual problem. Nevertheless, she remains optimistic that Malaysia will benefit from increased tourism from Middle Eastern countries which have declared two-week holidays for Eid Fitri, which marks the end of the fasting month.

This Year's Haze is Small Potatoes -- Literally
--- --

¶12. A representative from the Malaysian Vegetable Growers' Association told EconFSN that the haze -- produced largely by agricultural practices in Indonesia -- is hurting agriculture in Malaysia, as the prolonged lack of sunlight is inhibiting agricultural production, particularly the growth of green vegetables and chilies. He expects the effects of longer maturation times and smaller sizes to result in a shortage, causing prices to increase by as much as 20 per cent. However, this remains small potatoes compared to last year, which saw closures of airports due to poor visibility, and lengthy suspensions of operations at high-tech factories requiring "clean rooms," as the smoke overwhelmed their filtration systems. A manager at one local factory observed that

they did not have to close during the even more severe haze event of 1997 (reputed to be the region's worst year for haze), but today's clean rooms operate at much higher standards and thus are more sensitive to the quality of the ambient air supply. So far this year, we have heard no reports of factories or other facilities having to close due to haze, although the Malaysian government issued a maritime traffic warning due to poor visibility in portions of the Straits of Malacca.

Indonesia Announces It Will Fight Haze

¶13. At an ASEAN meeting in Pekanbaru last week, the Government of Indonesia apologized to haze-affected countries, and announced its intention to sign the 2002 ASEAN Transboundary Haze Agreement. According to press reports, Malaysian Foreign Minister Hamid Albar expressed frustration over ASEAN's ability to resolve the haze problem, asking for concrete results, not just sweet words.

LAFLEUR